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Nos. 360, 361

In the Supreme Court of the United States

OCTOBER TERM, 1940

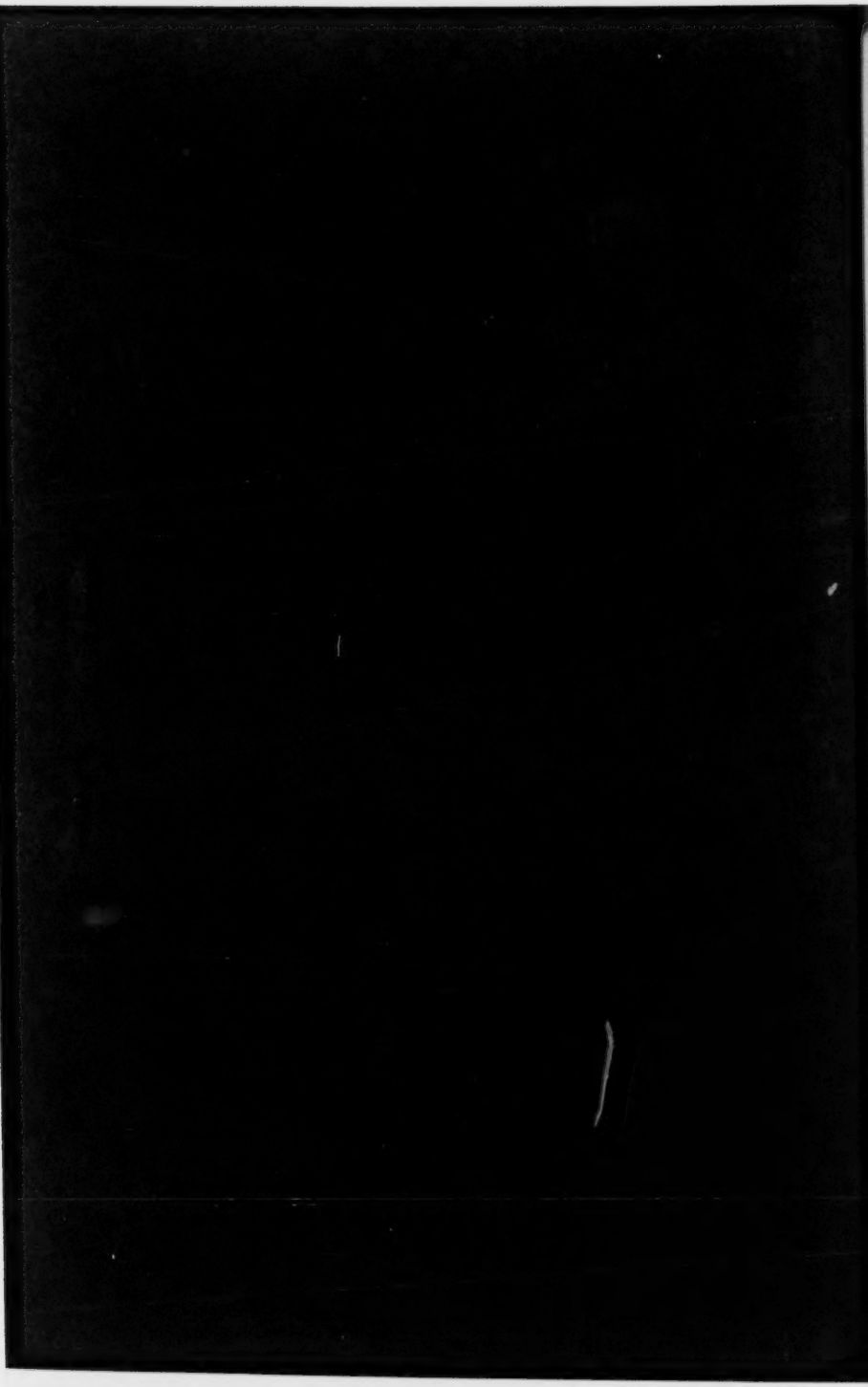
LONG ISLAND DRUG COMPANY, INC., PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION



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OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 27–36) is reported in 35 B. T. A. 328. The opinion of the Circuit Court of Appeals (R. 126–128) is reported in 111 F. (2d) 593.

JURISDICTION

The judgments [1] of the Circuit Court of Appeals were entered May 23, 1940 (R. 132–133). The pe-

[1] Both cases involved the same question and were consolidated for hearing and opinion before the Board (R. 27). They were disposed of in a single opinion by the court below (R. 126–128) but with separate judgments (R. 132, 133).

titions for writs of certiorari were filed August 22, 1940. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The question is whether the deduction from gross income given to a corporate taxpayer as "a reasonable allowance for salaries or other compensation for personal services actually rendered" should be increased to the extent of a portion of the compensation paid to its officers but disallowed by the Commissioner.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved will be found in the Appendix, *infra*, pp. 8–10.

STATEMENT

The facts, as found by the Board of Tax Appeals (R. 27–36), may be summarized as follows:

The taxpayer is a corporation, organized in 1917 under the laws of the State of New York, and has its place of business in Jamaica, Long Island. It is engaged in the distribution at wholesale of drugs manufactured by others (R. 28).

The authorized capital of the corporation was $10,000 (100 shares of $100 par value). It issued only 30 shares of stock, which were held equally by the brothers Hyman and Maurice Alkon, and Bernard H. Mindling. In 1921, each of the stock-

holders sold one-half of his stock to Benedict Maisel, the nominee of the Reliance Distributing Company, a total of 15 shares for approximately $39,000. The stock of this corporation was owned by the parents of Charles J. Steinberg. In 1926 or 1927, the Reliance Distributing Company was dissolved and the 15 shares of stock were transferred to the Cunard Mercantile Corporation, the stock of which was also owned by the parents of Steinberg. Charles J. Steinberg was not a stockholder of the taxpayer corporation, nor did he have any equitable interest in the stock (R. 28).

Prior to 1930, the taxpayer had not paid any dividends. The Steinberg family, who controlled a half interest in the taxpayer corporation, having failed to receive any return on their investment, desired that it extend its business operations by putting out a new line of goods and opening a new market in Brooklyn. They also wanted the taxpayer corporation to employ Charles J. Steinberg (R. 28).

The stockholders were unable to agree upon the future conduct of the business of the corporation and the Steinbergs, through their nominee, brought suit to dissolve the corporation. The suit was dismissed upon the condition that the corporation was to extend its market into Brooklyn, promote a new line of goods under its own brand, and employ Charles J. Steinberg to be in charge of the new line. The annual compensation of the officers of

the corporation, including Steinberg, was to be at fixed annual rates plus equal shares in 50% of net profits. The corporation carried out the terms of this understanding. The bylaws of the corporation were amended March 11, 1931, to provide for the annual compensation of officers as follows: President, $13,500; treasurer, secretary, and assistant secretary, $12,500 each. In addition to the annual salary, each of these officers was to receive 12½% of the net profits of the corporation after subtracting from net profits the total due on state and federal taxes (R. 28–29).

During the taxable years, the officers of the corporation were: President, Hyman Alkon; treasurer, Maurice Alkon; secretary, Bernard Mindling; assistant secretary, Charles J. Steinberg (R. 29).

Although the corporation handled more units of sales in 1932 and in 1933 than in 1931, its earnings were less because prices had fallen, due to the depression (R. 31).

In its returns for the years 1931, 1932 and 1933, the taxpayer deducted the amounts of $83,000, $61,000 and $61,000, respectively, as compensation of its officers. In determining the deficiencies for the years 1931, 1932, and 1933, the Commissioner disallowed the amounts of $32,000, $10,000 and $10,000, respectively, which represented 50% of the net income of the corporation paid as additional salaries. The Commissioner determined that the deductions for additional salaries represented a dis-

tribution of profits and not compensation for the value of services rendered and that the fixed annual salaries allowed represented reasonable compensation for services rendered (R. 11, 22, 30).

The Board of Tax Appeals, after weighing the evidence, including the total compensation paid each officer, comprising both salary and fixed percentage of net earnings, found that the proof was unsatisfactory and did not show that the amounts paid were reasonable and not more than reasonable (R. 35). The Board concluded that the taxpayer had failed to sustain the burden of proof to show that the Commissioner's determination was erroneous with respect to reasonable compensation and held that the amounts paid out of net earnings were not deductible as ordinary and necessary business expenses (R. 35).

On appeal, the Circuit Court of Appeals held that the Board had found the compensation paid, over and above the amount allowed by the Commissioner as deductible, was more than reasonable and affirmed the Board (R. 127–128).

ARGUMENT

1. Petitioner's contention (Pet. 4) that the case has been decided upon a mistaken view of the weight to be given to the Commissioner's determination has no support in the record. The Circuit Court of Appeals concluded (R. 128) that the Board had made "the equivalent of a specific find-

ing * * * that the compensation paid, over and above the amount allowed by the commissioner as deductible, was unreasonably high." Under this view of the Board's findings, which we submit is the correct one (see R. 34, 35), there was no occasion to decide the issue upon which petitioner relies.

Petitioner, quite naturally, urges (Pet. 4) that the Circuit Court of Appeals misinterpreted the action of the Board. But whether or not it did so, in this particular case, raises no question calling for review in this Court.

2. Petitioner also claims (Pet. 3) a conflict with *Ox Fibre Brush Co.* v. *Blair,* 32 F. (2d) 42 (C. C. A. 4th), affirmed on another ground, 281 U. S. 115. That case merely holds that, while the burden of proof is on the taxpayer, the action of its board of directors in voting salaries is entitled to a *prima facie,* not a conclusive, presumption of reasonableness. In the particular circumstances, the Fourth Circuit there held that the taxpayer had sustained the burden of proof. Here, after reviewing all the evidence, the Board reached a different conclusion and the Circuit Court of Appeals held that it was supportable. Petitioner's real objection is that the evidence before the Board was sufficient to compel a finding that the salaries paid to its officers were reasonable. That scarcely raises a question calling for further review.

CONCLUSION

The decision of the court below is correct. There is no conflict of decisions and no question of general importance is presented. The petitions for writs of certiorari should, therefore, be denied.

Respectfully submitted.

FRANCIS BIDDLE,
Solicitor General.

SAMUEL O. CLARK, JR.,
Assistant Attorney General.

J. LOUIS MONARCH,
JOHN A. GAGE,
Special Assistants to the Attorney General.

EDWIN E. HUDDLESON, JR.,
Attorney.

SEPTEMBER, 1940.

APPENDIX

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Statutes and Regulations Involved

Revenue Act of 1928, c. 852, 45 Stat. 791:

> Sec. 23. Deductions from gross income.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.
>
> * * * * *

Section 23 (a) of the Revenue Act of 1932, c. 209, 47 Stat. 169, is the same as Section 23 (a) of the Revenue Act of 1928, *supra*.

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

> Art. 121. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, * * *.

ART. 126. *Compensation for personal services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (*a*) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (*b*) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility.

While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable in all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises in like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

Articles 121 and 126 of Treasury Regulations 77, promulgated under the Revenue Act of 1932, are the same as Articles 121 and 126 of Treasury Regulations 74, *supra*.

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